

Winspear Business Reference Room
University of Alberta
1-28 Business Building
Edmonton, Alberta T6G 2R6

KROES ENERGY INC.



1997 ANNUAL REPORT

Kroes Energy Inc.
You have asked to be included on the mailing list
for information on Kroes Energy Inc. and it is our
pleasure to provide you with a copy of our 1997
Annual Report

CORPORATE PROFILE

Kroes Energy Inc. is a junior oil and gas exploration and production company headquartered in Calgary, Alberta, Canada and listed on the Alberta Stock Exchange. It is the objective of the Company to participate in oil and gas ventures both in Canada and outside of Canada.

The Company presently has interests in crude oil and associated gas production in western Saskatchewan; a carried interest in three exploration blocks off the south coast of Cuba; is farming into a 1,900 acre block on the Cedros peninsula of southern Trinidad which now produces a small volume of oil; and is farming into a 1,280 acre block in central Alberta that is prospective for crude oil.

DIRECTORS

Stephan V. Benediktson
Cochrane, Alberta

Fred Callaway
Calgary, Alberta

N. (Bill) Khouri
Calgary, Alberta

David E. Powell
Calgary, Alberta

Richard A. Wilson
Calgary, Alberta

OFFICERS

Fred Callaway
President

Richard A. Wilson
Secretary

ANNUAL MEETING

The Annual Meeting of the Shareholders will be held in Calgary on June 9, 1998 at 3:00 pm in the Cardium room of the Calgary Petroleum Club, 319 - 5 Ave. SW.

KROES ENERGY INC.

1997 ANNUAL REPORT

To the Shareholders

1997 was an eventful year for Kroes Energy Inc. and we are pleased to report that considerable progress has been made in building a junior oil and gas company with interests in Canada and abroad.

Financial and operating results

Production from our properties in Saskatchewan for 1997 averaged 62 barrels per day of crude oil, and associated natural gas production added a further 9 barrels of oil equivalent per day. These properties produced revenue of \$704,545 and generated net operating income of \$154,165 during 1997. Crude oil prices weakened near the end of the year but the average price received for our crude oil in 1997 was \$26.93 per barrel. The decline in oil price caused the Company to experience a ceilings test write-down of \$262,666 under its accounting policies and therefore a net loss of \$345,626 was incurred for the year.

Cash flow from operating activities was \$60,324 (\$0.01 per share) and represents revenues after deducting all direct field operating costs, surface and mineral rentals and general and administrative costs incurred during 1997.

Sale of properties

Early in 1998 Kroes reached agreement to sell its interests in the Eureka field in eastern Saskatchewan to a private company operating in that province. The sale transaction closed on March 24, 1998 and total proceeds from the sale, including closing adjustments, amounted to \$136,800. The Company retains its interests in the nearby Druid and Whiteside fields where its share of production in 1997 averaged 53 barrels of oil equivalent per day.

Rights offering

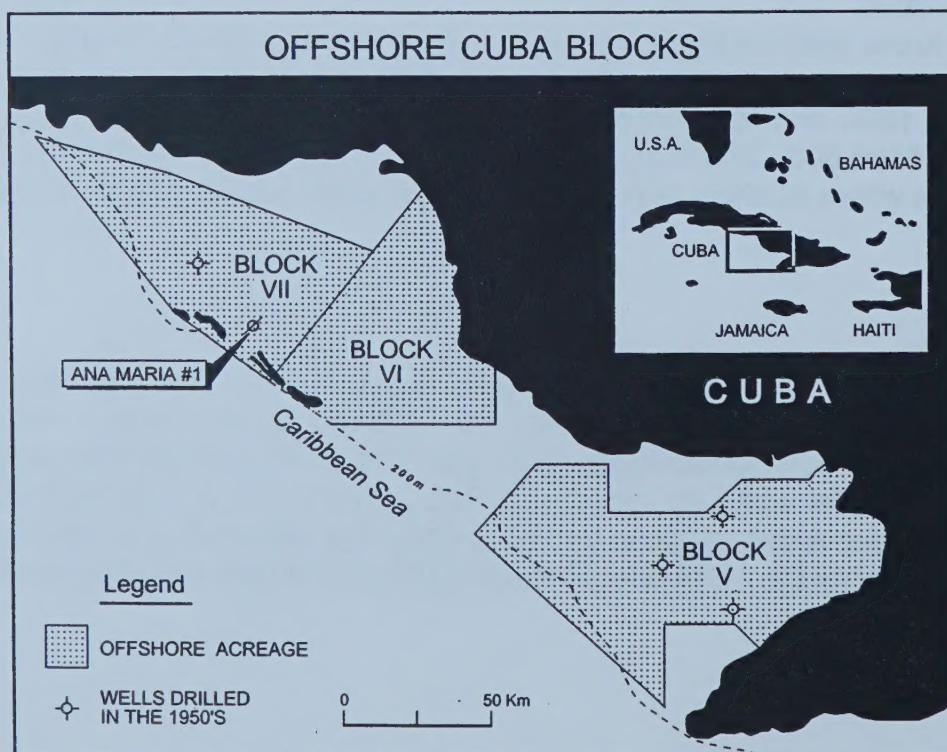
In December of 1997, the Company initiated a rights offering. One right was issued for each share outstanding, and the holder was entitled to purchase one new common share for twenty cents by tendering two rights. A total of 3,565,286 common shares would have been issued if the offer was fully subscribed. The timing of this offering was unfortunate, as both the small cap equity markets and oil prices were depressed. On the expiration of the rights on January 26, 1998 a total of 1,518,870 shares were issued for proceeds of \$303,774.

Cuba

In February of 1997 Kroes initiated a takeover bid for Hogar Energy Inc. whose principal asset was a 7.5% working interest in Blocks V, VI and VII off the south coast of Cuba. The Cuban project involved the obligation to pay 10% of the cost of the first exploratory well in order to earn a 7.5% working interest in the 2.2 million acres contained in the Blocks. Hogar already had advanced \$600,000 to the Operator to pay it's share of the estimated cost of the first well. The takeover was completed in March and Kroes issued 3,430,471 new shares in a one-for-one exchange for the outstanding Hogar shares.

Some 4,000 kilometers of seismic surveys have been carried out on Blocks V, VI & VII and interpretation of the data has identified 25 prospects and leads, some of which could contain in excess of 300 million barrels of oil. Three of the features have sufficient seismic coverage to justify drilling. The well Ana Maria #1 was located on Block VII some 90 kilometers offshore. A conventional land rig was located on a coral key and drilling began in June, 1997. The well was completed late in July and encountered oil and gas shows but did not produce hydrocarbons during testing. The well appears to have been located on the flank of the structure.

With the drilling of Ana Maria #1 Kroes Energy earned it's 7.5% working interest in Blocks V, VI and VII, but in November of 1997 it reached agreement to convert to a carried interest. Under this carried interest, Kroes will receive 4.875% of the revenue from production after deducting operating and capital cost recovery and government share. As a result of this agreement, the Company will not be required to fund it's share of the cost of the extensive exploration program planned for the blocks, nor the development costs associated with discoveries. It will, however, receive cash flow from the beginning of production as the production sharing contract limits the amount of cost recovery that can be claimed in each quarter.

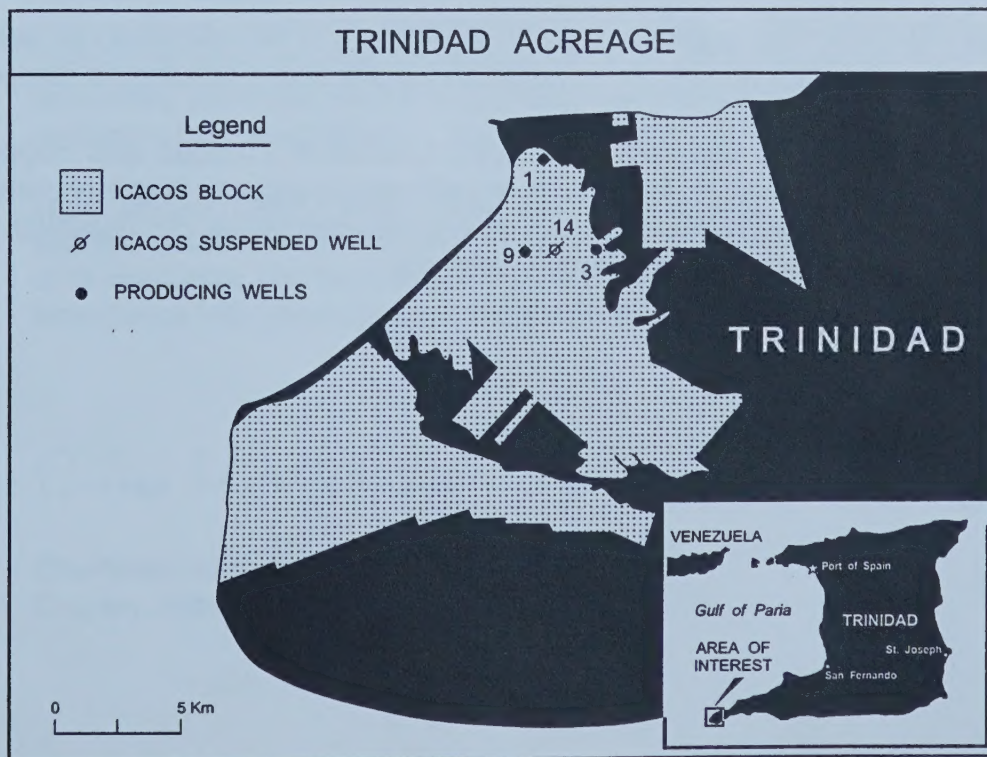


This is a very significant interest for Kroes Energy as it provides continuing exposure to potentially large discoveries without the obligation to contribute to the extensive exploration and development programs that will be required. There was sufficient encouragement following the drilling of Ana Maria #1 for the partners to plan for 1998, a gravity survey to locate the crest of the same structure where a follow-up well will be drilled later in 1998. While the structure will not contain in excess of 1 billion barrels as was thought possible prior to the drilling of Ana Maria #1, there still is sufficient room for an accumulation of up to 500 million barrels. Some new working interest partners have joined the group and it is expected that an aggressive exploration program will be carried out over the next few years on all three of the Blocks.

Trinidad farm-in

In November, 1997 Kroes entered into a participating agreement with Eastern Petroleum Australia P/L to earn a 25% working interest in the 1,900 acre Icacos Block on the Cedros Peninsula of Trinidad. The block is presently held by Premier Oil PLC, a large international oil and gas company headquartered in London, England. To earn the interest, Kroes and Eastern each must pay 50% of the cost to drill two wells to a maximum depth of 3,500 feet and each well is expected to cost about \$500,000. Kroes also will earn it's 25% working interest in existing production from the block, which has just recently increased from 15 barrels per day to 30 barrels per day following the recompletion of one of the three producing wells. The agreement also provides for Kroes to recover it's share of costs from new production before the farmor receives a share of the proceeds.

There are a total of 13 wells previously drilled on the block and there is potential to re-enter some of them to enhance or initiate production. The two earning wells will be step-outs from existing producers and expect to encounter the same producing sands in an up-dip position. New wells should be capable of producing up to 100 barrels of oil per day, although some of the existing wells produced in excess of 300 barrels of oil per day when



they were brought on stream. There also is a deep exploratory prospect on the eastern portion of the block which will be investigated following evaluation of the producing area.

The first earning well, Icacos #14, began drilling on December 15, 1997 and was suspended early in January after encountering water and low oil saturation in an upthrown fault block. A review of technical data from existing wells was completed early in April, 1998, and it indicated the need for a seismic program to provide information to better select well locations and lower the dry hole risk in this complex region. It also would provide information necessary to come to a decision on the feasibility of deviating the suspended #14 well into the productive Cruse sands that are present in a nearby producing well. Negotiations were initiated with Premier Oil PLC to substitute a 50 kilometer seismic program for the second earning well in the farmout agreement and the parties reached agreement in principal late in April. Kroes now will earn its 25% interest in the Icacos Block on completion of the seismic program.

Plans for 1998

In February of 1998, Kroes agreed to take a 10% interest in a farm-in to an exploratory Leduc oil play (the Davy Prospect) located on a 1,280 acre block in central Alberta. The Company and its partners undertook to complete a 3-D seismic program and drill a well to 8,500 feet to test the prospect. If the well is successful, the partners will recover their costs then Kroes' working interest will revert to 5.5%. This is a high reward project for Kroes as production and reserves for similar anomalies in the vicinity indicate potential initial production rates of up to 700 barrels per day and recoverable reserves of up to two million barrels. The seismic survey is expected to commence in May, 1998 and if the results are encouraging, the well will be drilled in the third quarter.

To summarize Kroes Energy's activities for 1998 in Cuba, the gravity survey over the Ana Maria structure has been completed and the consortium is in the process of selecting the location of the second well that will be drilled late in the summer.

In Trinidad we will undertake approximately 50 kilometers of two dimensional seismic on the Icacos block and a well will be drilled as soon as practical following its completion.

The Directors of Kroes are seeking other opportunities in Trinidad and hope to add additional projects during the year. In addition, we will review opportunities that come to our attention elsewhere in the world where small international companies can establish a niche operation that does not compete with large operators.

A handwritten signature in dark ink, appearing to read 'Fred Callaway', with a stylized, sweeping flourish at the end.

Fred Callaway, President

May 4, 1998

March 13, 1998

AUDITORS' REPORT

***To the Shareholders of
Kroes Energy Inc.***

We have audited the balance sheets of **Kroes Energy Inc.** as at December 31, 1997 and 1996 and the statements of operations and deficit and changes in financial position for the periods then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1997 and 1996 and the results of its operations and the changes in its financial position for the periods then ended in accordance with generally accepted accounting principles.

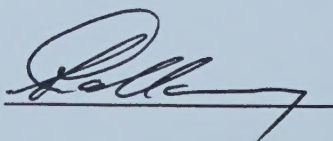
Price Waterhouse

**Chartered Accountants
Calgary, Alberta**

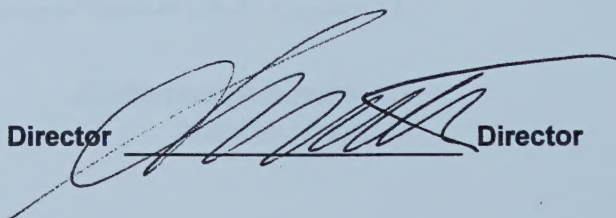
BALANCE SHEET

	December 31	
	1997	1996
Assets		
Current assets		
Cash	\$ 3,884	\$ 2,952
Accounts receivable	40,366	88,530
Prepaid expenses and deposits	79,138	40,111
Advances	2,808	-
	126,196	131,593
Capital assets (Note 2)	1,294,305	804,921
	\$1,420,501	\$ 936,514
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 221,660	\$ 25,490
Current portion of promissory note (Note 3)	-	56,000
Shareholder's loan, unsecured, non-interest bearing	40,000	-
	261,660	81,490
Promissory Note (Note 3)	-	414,000
Site restoration	9,213	-
Shareholders' Equity		
Share capital (Note 4)		
Common shares issued	1,513,437	459,207
Deficit	(363,809)	(18,183)
	1,149,628	441,024
	\$1,420,501	\$ 936,514
Subsequent event (Note 8)		

Approved by the Board



Director



Director

STATEMENT OF OPERATIONS AND DEFICIT

	Year ended December 31 1997	Period ended December 31 1996
Revenue		
Production	\$ 646,901	\$ -
Interest income	837	2,815
	647,738	2,815
Expenses		
General and administrative	94,678	12,618
Operating	492,736	8,380
Depletion, depreciation and amortization	126,748	-
Additional depletion (Note 2)	262,666	-
Future site restoration	16,536	-
	993,364	20,998
Net loss for the period	(345,626)	(18,183)
Deficit, beginning of period	(18,183)	-
Deficit, end of period	\$ (363,809)	\$ (18,183)
Net loss per share	\$ 0.06	\$ 0.01

STATEMENT OF CHANGES IN FINANCIAL POSITION

	Year ended December 31	
	1997	1996
Cash (used in) provided by operating activities		
Net loss for the period	\$ (345,626)	\$ (18,183)
Add back non-cash items		
Depreciation, depletion and amortization	126,748	-
Site restoration	16,536	-
Additional depletion	262,666	-
	60,324	(18,183)
Change in non-cash working capital	212,264	(103,151)
Actual site restoration costs	(7,323)	-
	265,265	(121,334)
Cash provided by (used in) financing activities		
Issue of common shares for cash	32,500	259,207
Issue of common shares for the purchase of Hogar Energy Inc.	1,021,730	-
Promissory note	(470,000)	470,000
Deposit for financing	-	7,000
	584,230	736,207
Cash (used in) provided by investing activities		
Purchase of Hogar Energy Inc., net of cash \$16,522	(1,025,908)	-
Hogar Energy Inc. promissory note	470,000	-
Acquisition of oil and gas properties	(309,253)	(804,921)
Proceeds on disposal	16,598	-
	(848,563)	(804,921)
Change in cash for the period	932	(190,048)
Cash at beginning of period	2,952	193,000
Cash at end of period	\$ 3,884	\$ 2,952

NOTES TO FINANCIAL STATEMENTS

December 31, 1997

1 Significant accounting policies

a) Full cost method of accounting

The Company follows the full cost method of accounting whereby all costs relating to the exploration for, and the development of, oil and natural gas reserves are capitalized on a country-by-country cost centre basis. Costs accumulated within each cost centre are depleted and depreciated using the unit-of-production method, based on estimated proved reserves with production and reserves volumes of natural gas converted to equivalent energy units of crude oil. Proceeds from disposal of properties are normally deducted from the cost centre except when the disposition results in a significant change in the depletion rate in which case a gain or loss on disposal is recognized.

Costs of exploration in new cost centres, together with related land costs, are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties, or if impairment has occurred.

In determining the depletion and depreciation provisions for oil and natural gas assets, the Company includes any excess of the net book value of those oil and natural gas assets over the unescalated, undiscounted future net operating revenues from its proved oil and natural gas reserves for each cost centre (ceiling test). A second ceiling test calculation is conducted on an enterprise basis, by including in the depletion and depreciation provisions any excess of the net book value of oil and natural gas assets less deferred taxes and the future dismantlement and site restoration costs for all cost centres over the unescalated, undiscounted future net revenues from proved oil and natural gas reserves, plus the cost of undeveloped properties, less future general and administrative expenses, financing costs and income taxes.

b) Future dismantlement and site restoration costs

Estimated future dismantlement and site restoration costs for oil and gas assets are provided using the unit-of-production method.

c) Joint ventures

Substantially all of Kroes's oil and gas exploration, development and production activities are conducted jointly with others. The financial statements reflect only Kroes's proportionate interest in such activities.

d) Foreign currency translation

- Monetary assets and liabilities - at the period-end rate of exchange.
- Other assets and liabilities - at historical rates of exchange
- Revenues and expenses - at monthly rates of exchange except provisions for depletion and depreciation which are translated on the same basis as the related assets.

Unrealized gains and losses on translation to Canadian dollars of long-term monetary assets and liabilities are deferred and amortized over the remaining lives of the related assets and liabilities.

e) Net income (loss) per share

Net income (loss) per share is calculated using the weighted average number of shares outstanding.

NOTES TO FINANCIAL STATEMENTS**December 31, 1997****2 Capital assets**

	1997	1996
Office furniture and equipment	\$ 3,874	\$ -
Intangible oil and gas properties	1,540,640	649,176
Tangible oil and gas equipment	139,205	155,745
	1,683,719	804,921
Accumulated depletion and depreciation	(389,414)	-
	\$ 1,294,305	\$ 804,921

The ceiling test write-down for Canadian assets was \$262,666. The ceiling test for Canada used average prices for the year. The use of year end prices would have reduced the Canadian assets to zero and additional depletion of \$399,197 would have been provided.

Included in intangible oil and gas properties is the cost associated with Cuban assets of \$602,681 which is the amount paid by Kroes to earn the interest presently held. Although a dry hole was drilled on the acreage, the asset is not deemed impaired as a followup well will be drilled in 1998 on the earned acreage. In addition, a recent third party property transaction involving this acreage indicates continued commercial value.

3 Promissory note

Upon amalgamation of Hogar Energy Inc. and Kroes Energy Inc. the intercompany balance of \$470,000 for the promissory note was eliminated. (See Note 7.)

NOTES TO FINANCIAL STATEMENTS**December 31, 1997****4 Share capital**

The Company's authorized share capital is an unlimited number of Common Shares and an unlimited number of Preferred Shares issuable in series. No Preferred Shares have been issued.

Common Shares issued

3,575,000	Beginning balance, December 31, 1996	\$ 459,207
3,430,471	Amalgamation of Hogar Energy Inc. (net of financing legal fees of \$20,700)	1,021,730
75,000	at \$0.20 exercised under agent's options	15,000
50,000	at \$0.35 Warrants of Hogar Energy Inc. exchanged for shares in Kroes Energy Inc.	17,500
<u>7,130,471</u>	<u>Issued and outstanding at December 31, 1997</u>	<u>\$ 1,513,437</u>

Options to purchase 350,000 Common Shares at \$0.20 per share were granted to directors and officers of the Company in 1996. The options expire September 24, 2001.

262,709 Warrants were issued to purchase Common Shares at a price of \$0.35. The warrants expire December 31, 1998.

See Note 8.

5 Income taxes

The Company has income tax pools for intangible costs and tangible costs of approximately \$1,531,000 and \$ 143,030, respectively, and share issue costs of \$ 50,000 which can be claimed for tax purposes in future years.

6 Geographic segments

	Canada	December 31, 1997		Total
		Cuba	Trinidad	
Net revenue	\$ 647,738	\$ -	\$ -	\$ 647,738
Loss for the period	(345,626)	-	-	(345,626)
Identifiable assets	529,216	602,681	288,604	1,420,501

In 1996, all operations were in Canada.

NOTES TO FINANCIAL STATEMENTS**December 31, 1997****7 Acquisition**

In May of 1997, Kroes Energy Inc. purchased all of the outstanding shares of Hogar Energy Inc. Kroes issued common shares on a 1 for 1 basis, for the Class B common voting shares of Hogar Energy Inc.

The acquisition was accounted for as a purchase. The purchase price equation was as follows:

Cash	\$ 16,522
Accounts receivable	2,509
	<hr/>
	19,031
Promissory note receivable	*470,000
Advances under Participation Agreement	586,143
	<hr/>
	1,075,174
Accounts payable	(32,744)
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Purchase price prior to acquisition costs	\$ 1,042,430
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*The promissory note received from the Company was eliminated on amalgamation.

8 Subsequent event

Subsequent to December 31, 1997, Kroes Energy Inc. entered into an agreement to sell certain properties. The price of \$125,000 will be applied against the asset pool.

Kroes Energy Inc. issued to the holders of its outstanding Common Shares as of close on December 23, 1997, rights to purchase 3,565,286 additional Common Shares at a price of \$0.20 per share. These rights expired as of 4:30 p.m. January 26, 1998. Proceeds of \$ 303,774 were received from the issue of 1,518,870 shares.

**KROES ENERGY INC.
CORPORATE INFORMATION**

Offices

260, 435 - 4 Avenue SW
Calgary, Alberta, Canada
T2P 3A8

Banker

Bank of Nova Scotia
Calgary, Alberta, Canada
San Fernando, Trinidad, West Indies

Auditor

Price Waterhouse
Calgary, Alberta

Solicitor

McCarthy Tetrault
Calgary, Alberta

Transfer Agent

Montreal Trust Company of Canada
Calgary, Alberta

Stock Exchange Listing

Alberta Stock Exchange
Trading Symbol: KRS



Kroes Energy Inc.